



The State of the Economy and Prospects for Tax Revenue in Tennessee

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The State of the Economy and Prospects for Tax Revenue in Tennessee

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The Balance of News

U.S. Growth Is Established But Problems Remain

U.S. posting strong economic growth

- Growth should be around 4.5% this year and a bit beneath 4% for 2005

Policy remains supportive of growth

- Removal of liquidity has been tempered so far this year, and the FOMC is expected to accelerate the process in the near-term

Global growth is mixed

- China's growth remains strong
 - But risk of a hard landing remains
- Japan's economic recovery could be affected by the dollar
- European growth remains weak

International tensions remain

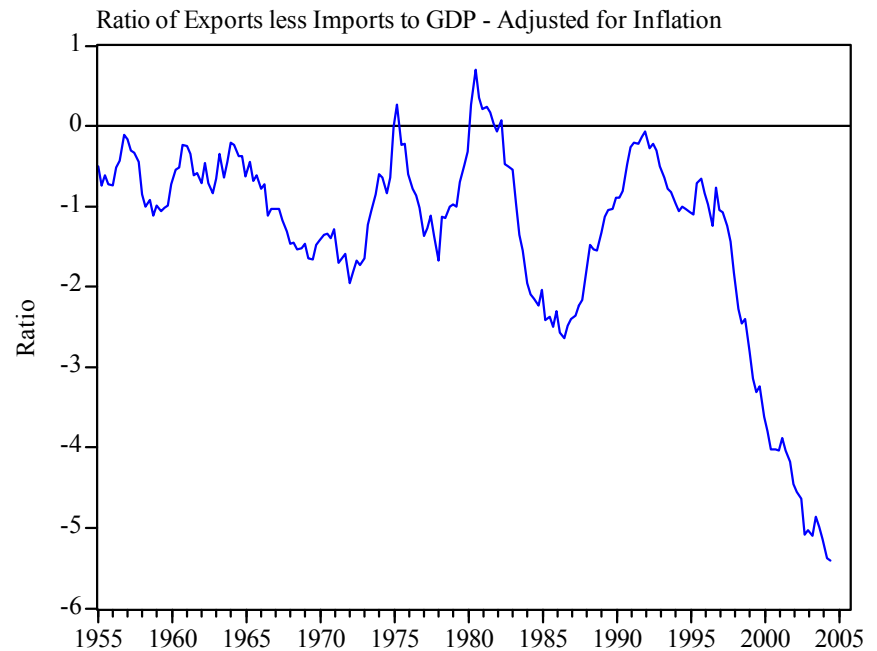
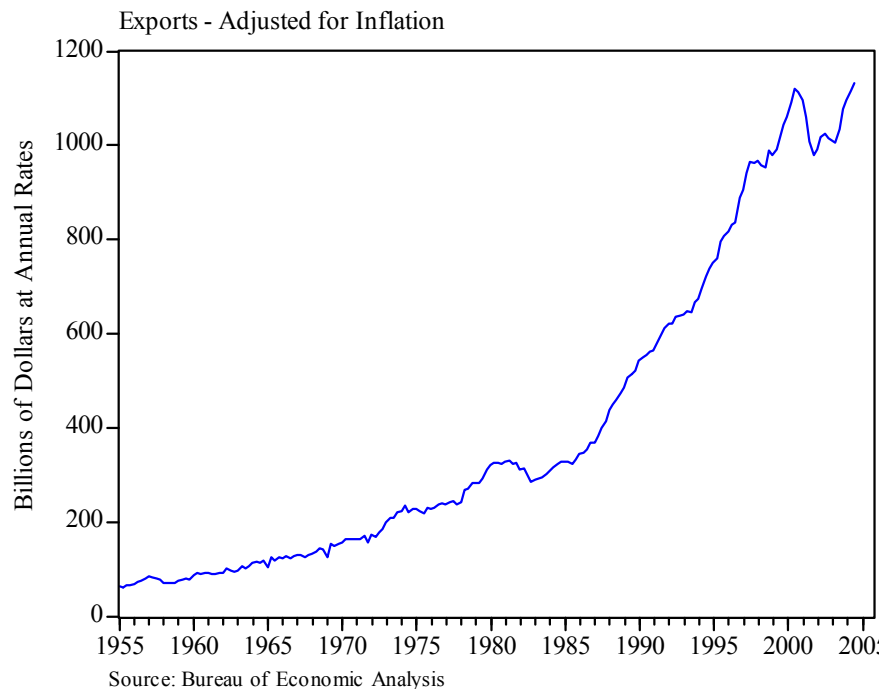
- EU Commission lowers growth forecast
- U.S. current account deficit very large
- Dollar remains under pressure

Domestic difficulties are also present

- Consumer confidence has faltered
- Leading indicators have faltered
- Equity and bond markets remain in tug-of-war over likely direction of economy
- Deflation in goods-producing sectors remains not an immediate problem; but sector still lacks pricing power
- Housing starts and vehicle sales remain high and could be vulnerable

The U.S. Cycle in Perspective

The U.S. in the Global Economy



The U.S. Business Cycle in Perspective

Recovery in Technology Spending Still Dominates the Investment Spending Picture

Business equipment and software

- More than half of total is devoted to information-processing equipment
- Remainder is spread among industrial, transportation, and other equipment

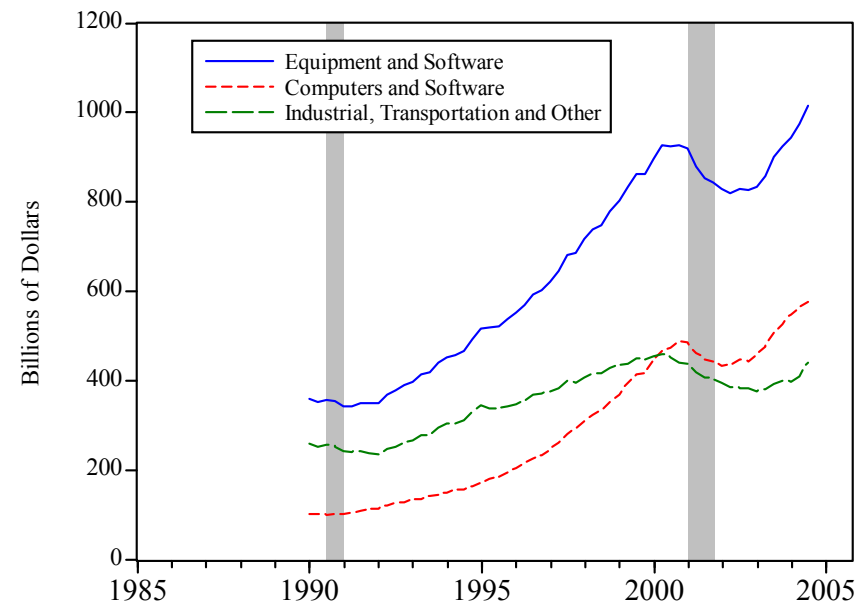
Falloff in spending on conventional equipment led the decline in spending on computers and software

Upturn technology spending led the upturn in general investment spending

The upturn in technology spending is likely behind the big productivity gains in the current national economic recovery

While increasing, spending on general investment goods is still beneath the last cyclical peak

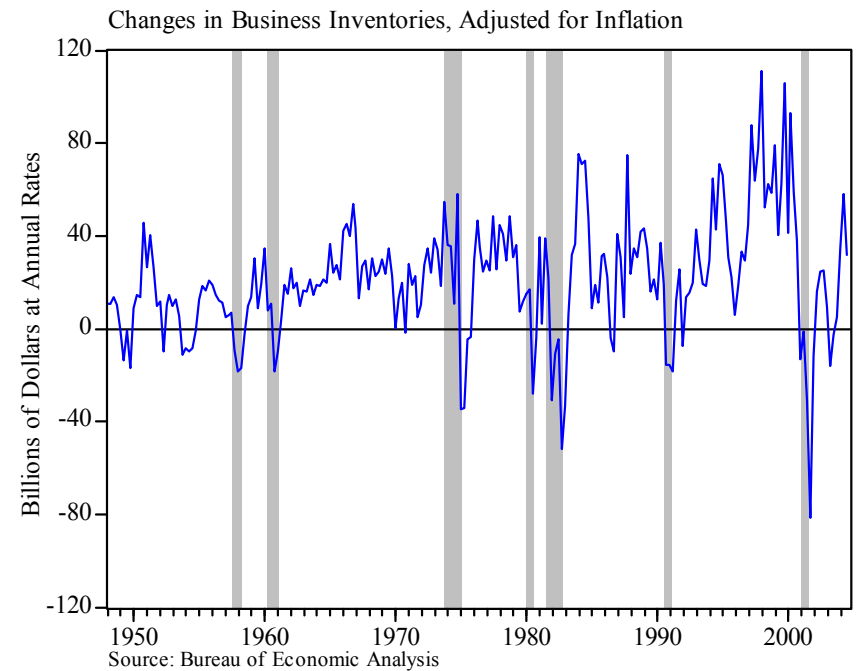
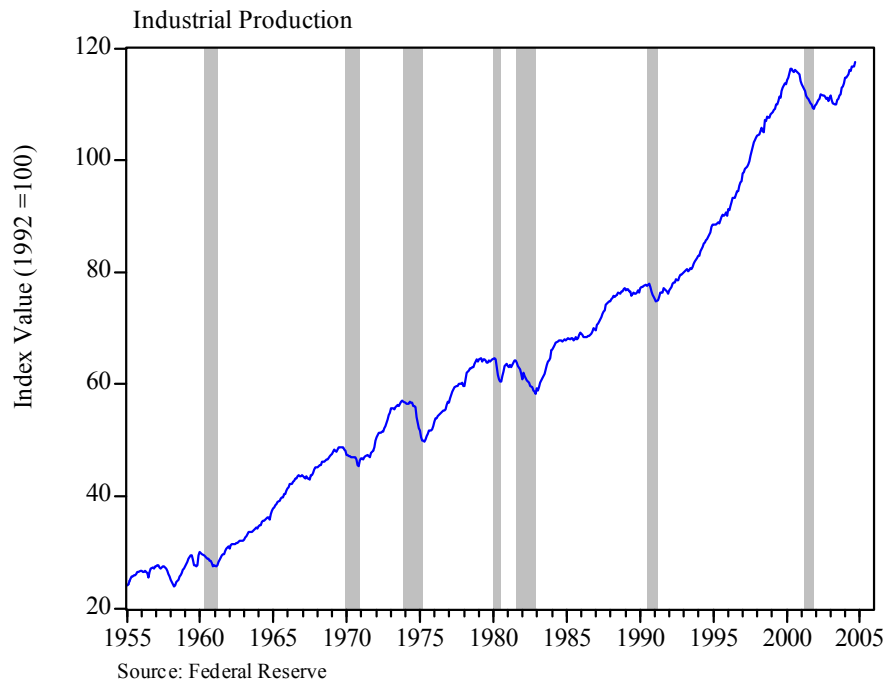
This reflects excess capacity and uncertainty surrounding prospects for profit growth



Source: Bureau of Economic Analysis

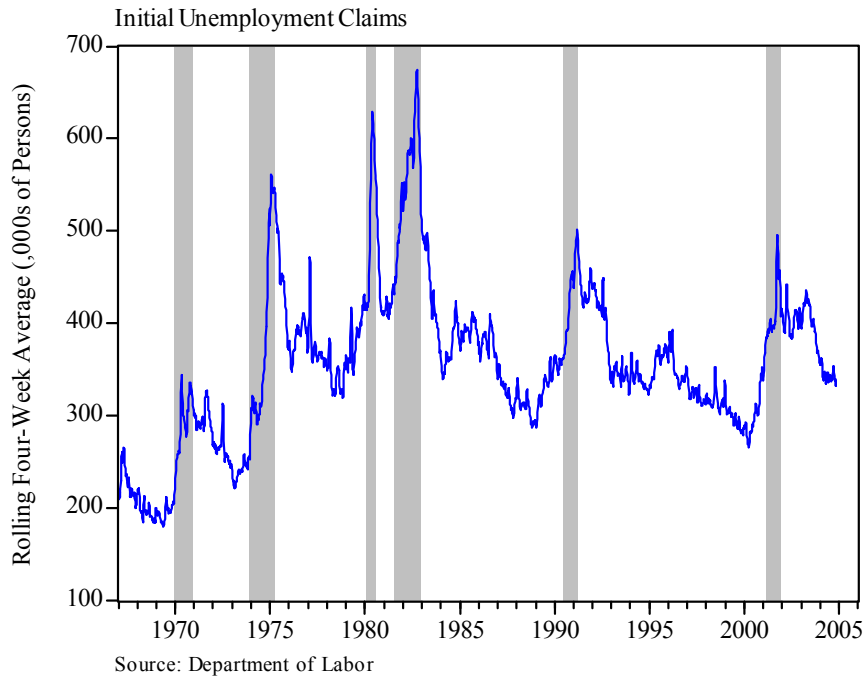
The U.S. Cycle in Perspective

Industrial Output and Changes in Inventories



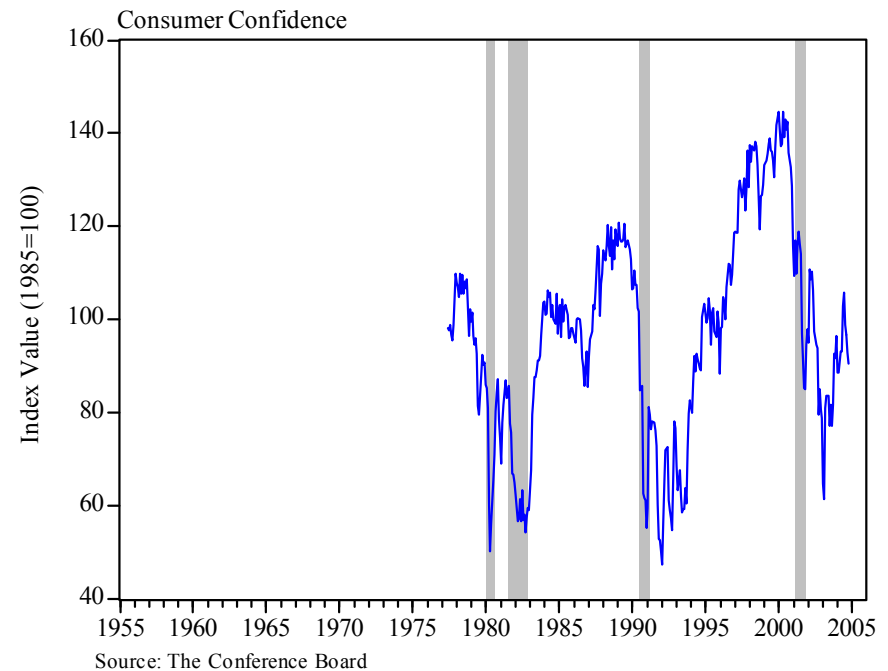
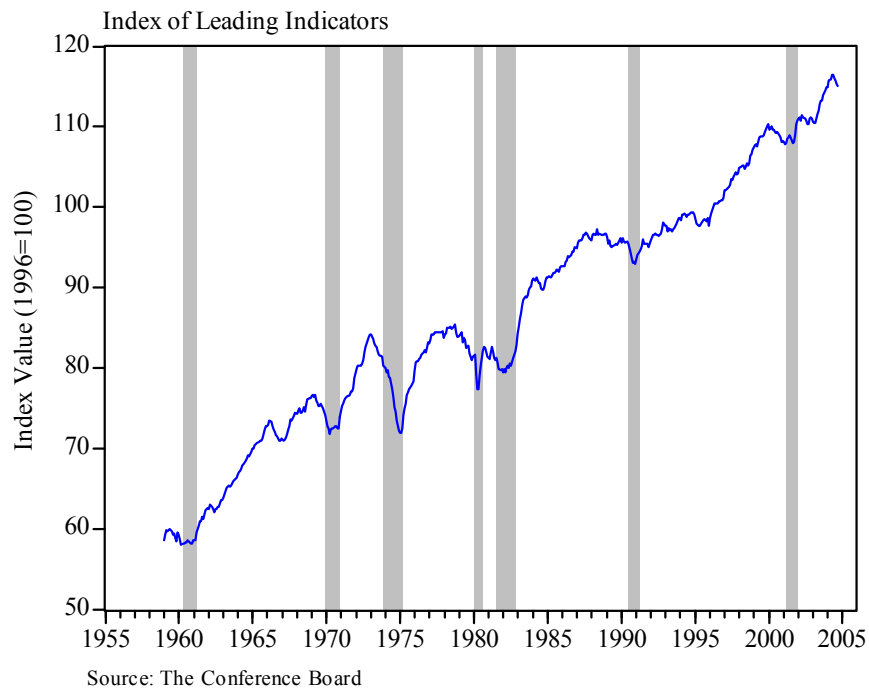
The U.S. Cycle in Perspective

Labor Markets: Initial Unemployment Claims and the Duration of Unemployment



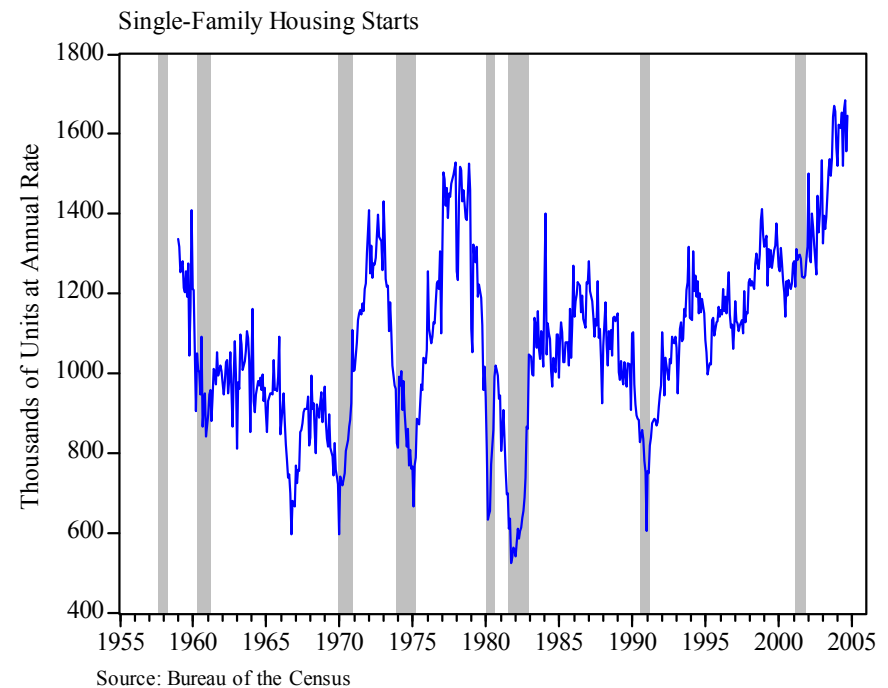
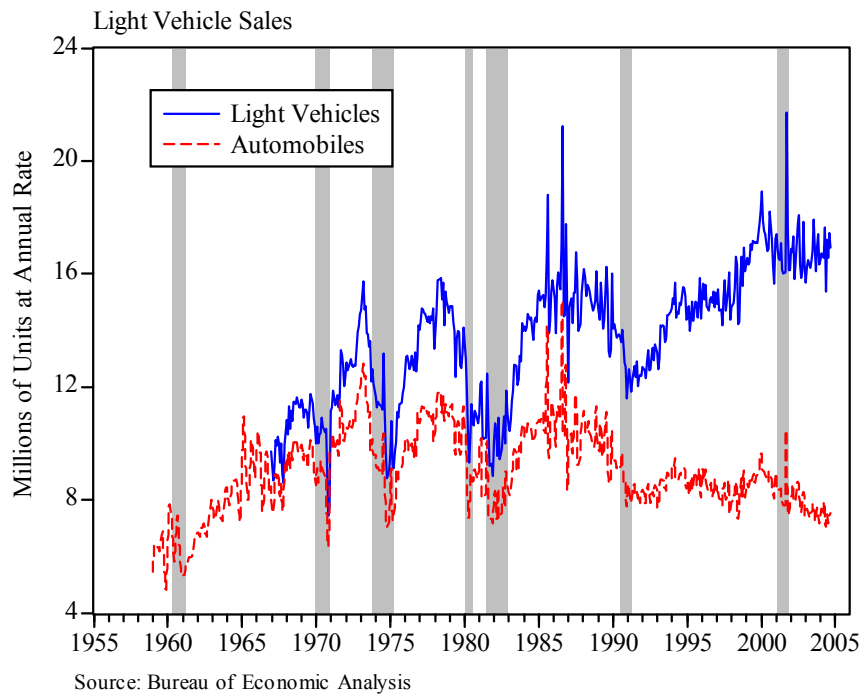
The U.S. Cycle in Perspective

Leading Indicators and Consumer Sentiment



The U.S. Cycle in Perspective

Light Vehicle Sales and Housing



The U.S. Cycle in Perspective

Equity Prices

2004 will be the second year to post a December-to-December gain after three years of declines

Gains are less pronounced this year compared with 2003

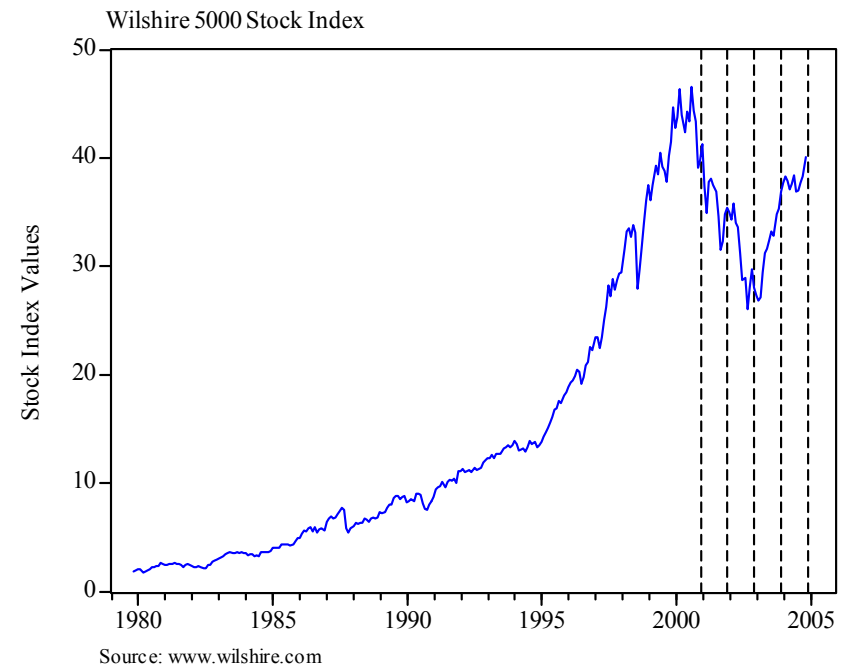
Generally, wealth effect has had minimal effect on spending

- Wealth loss in three previous years did not adversely affect consumer spending

Lackluster gains so far this year could be symptomatic of continued uncertainty over

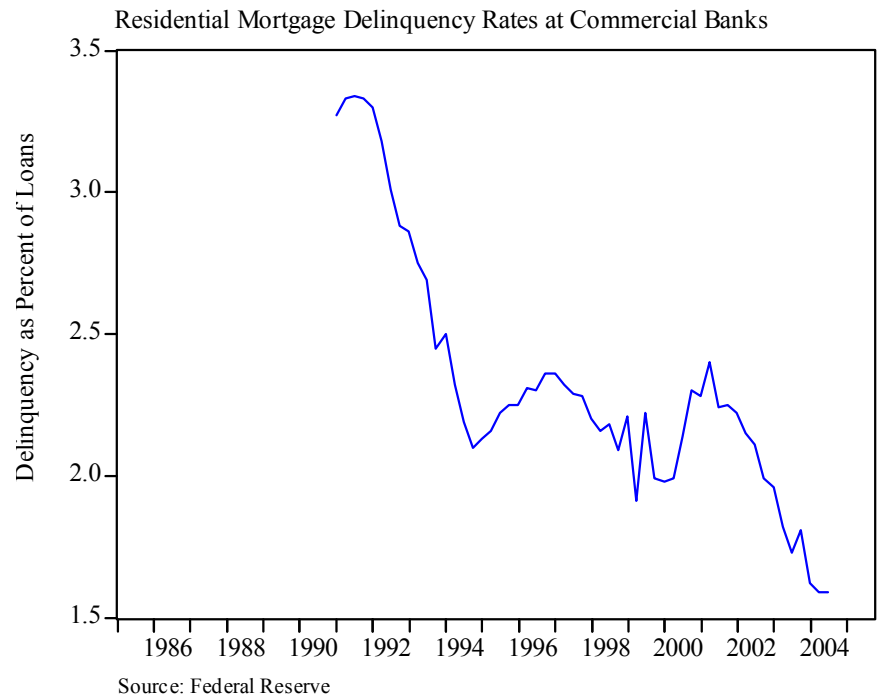
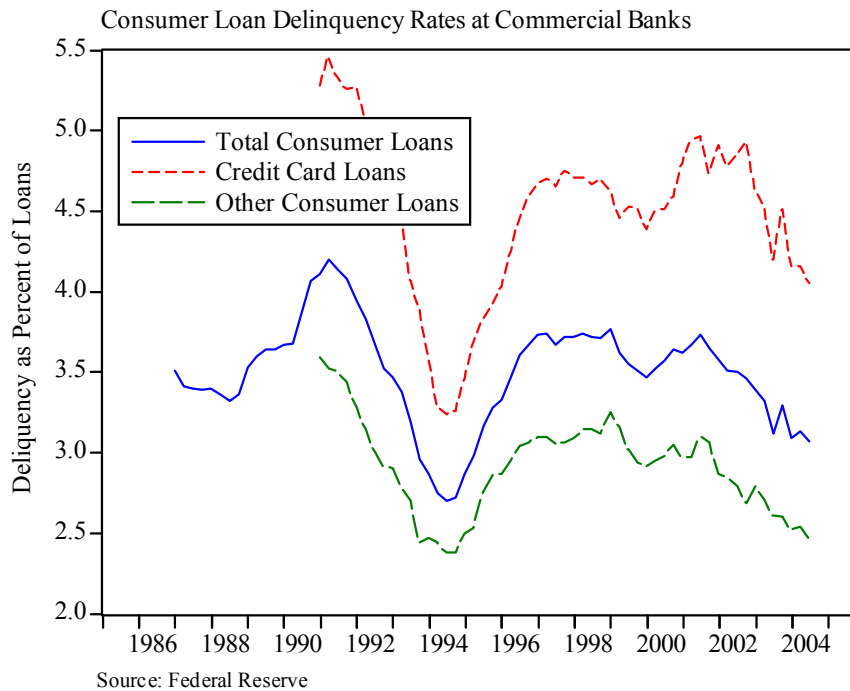
- The strength of the economy
- The strength of earnings growth
- The valuation of equity market
- The dollar and possible movement out of dollar-based assets
- Iraq and global terrorism

The economy, profits, and the dollar will likely pose more of a threat to outlook for 2005 than global terrorism



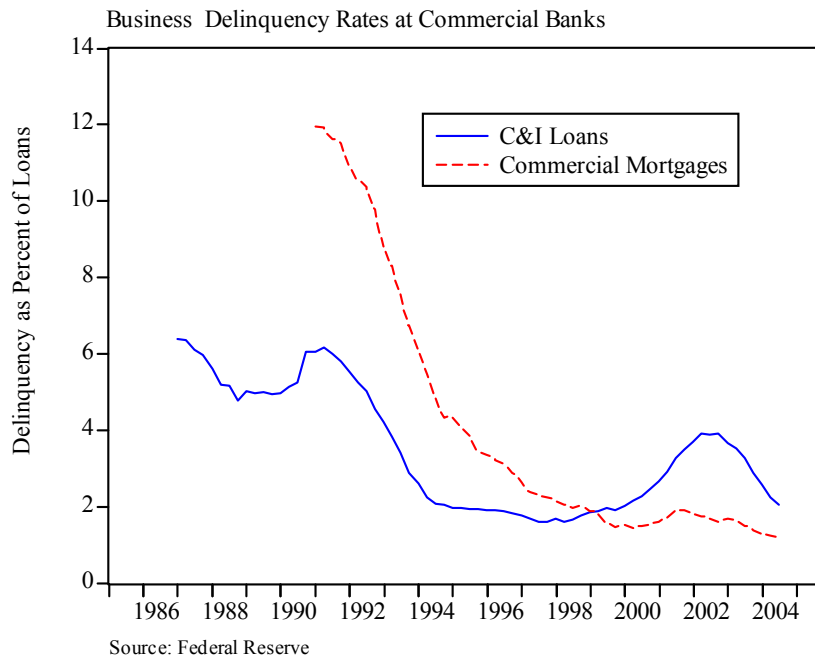
The U.S. Cycle in Perspective

Household Delinquency Rates at Commercial Banks



The U.S. Cycle in Perspective

Business Delinquency Rates at Commercial Banks



C&I loan delinquencies continue their decline

Delinquencies among commercial real estate did not turn upward during the 2000 recession

Looking forward, there is very good news in the lending area

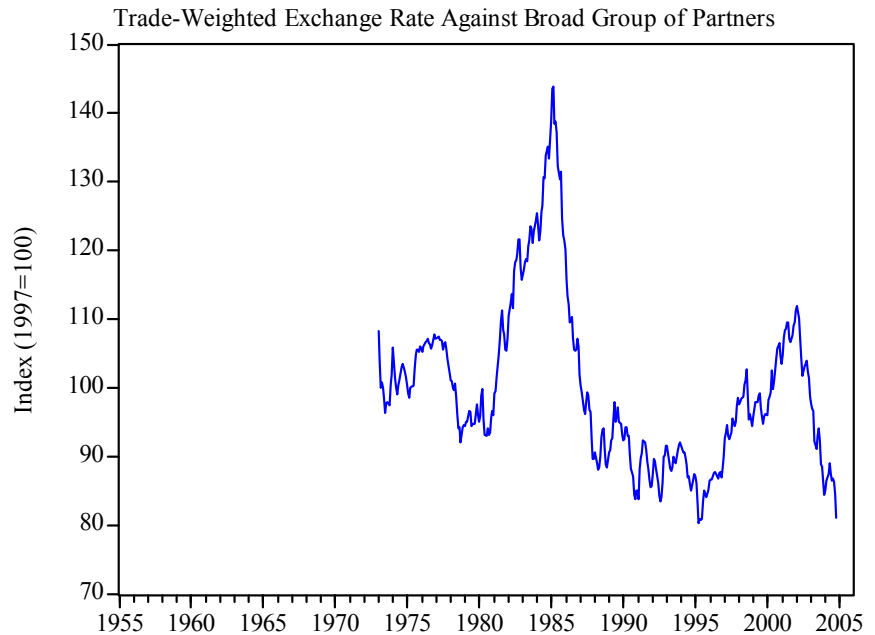
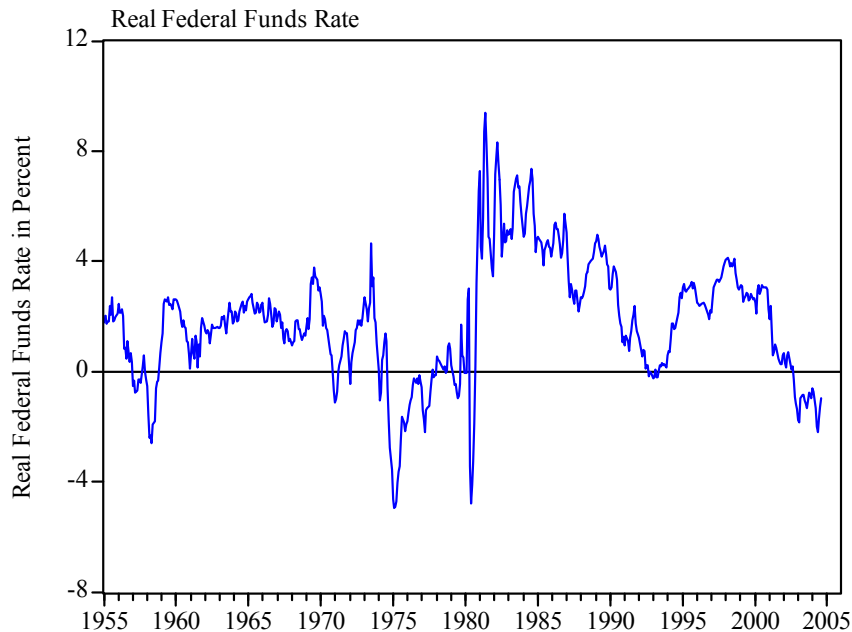
- Bank capital is excellent—a far different condition from the aftermath of the 1990 recession
- The FOMC's liquidity injections have assured availability of loanable funds

Bottom line:

- The economy has ample ability to continue to finance the current business expansion

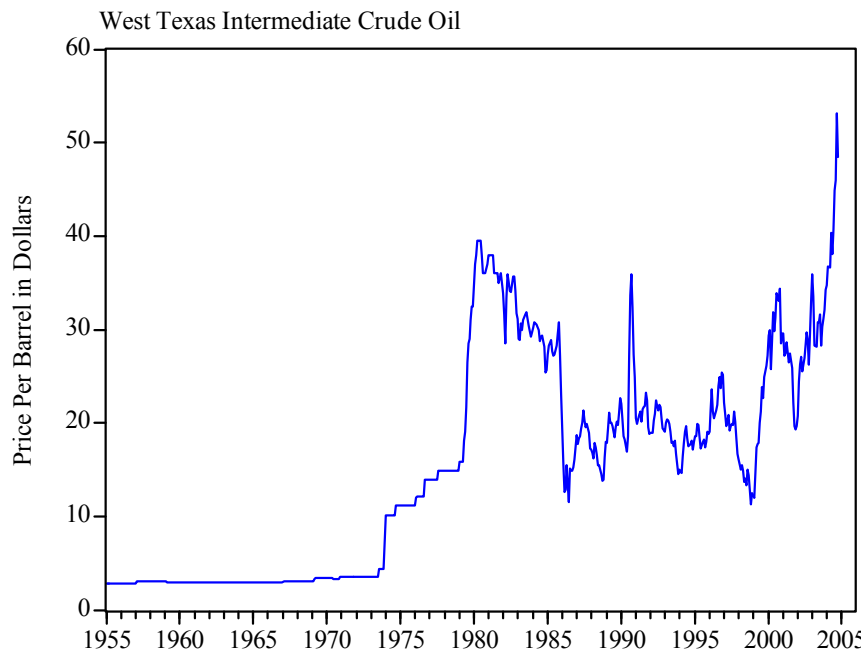
The U.S. Cycle in Perspective

Negative Forces: Excessive Monetary Stimulus , Exchange Rate, Oil Prices, and Household Financial Obligations



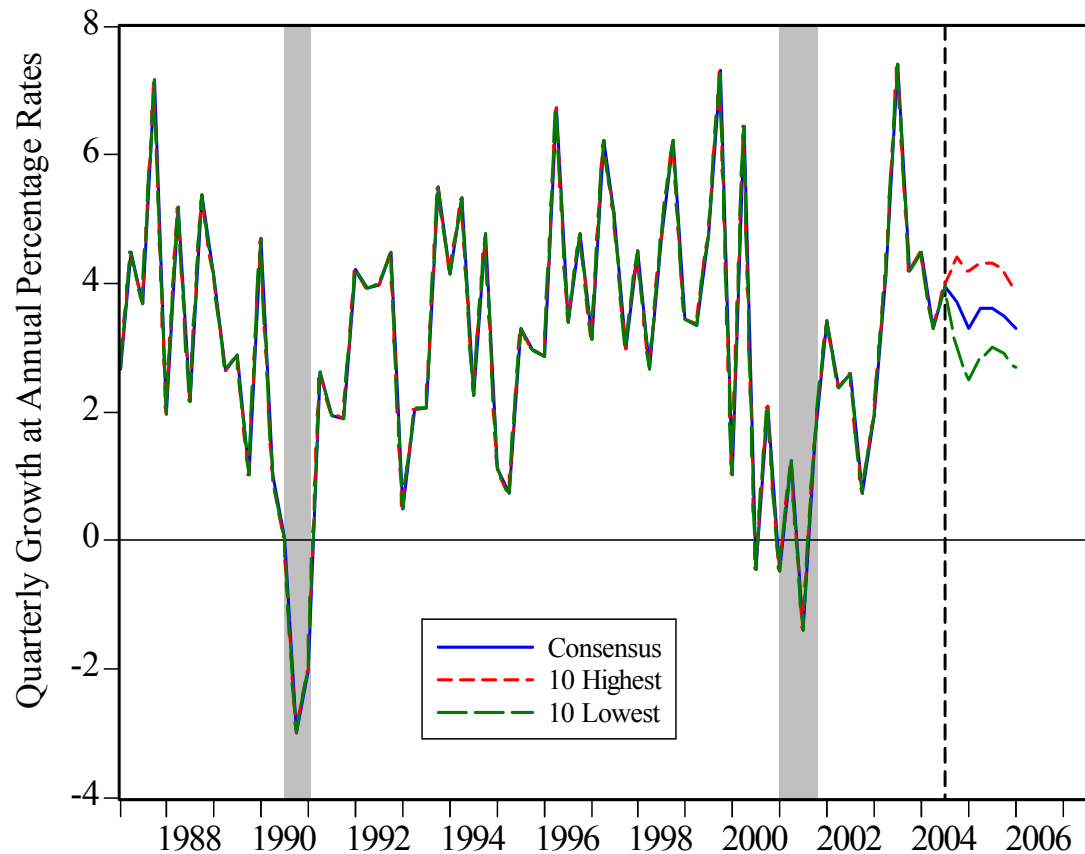
The U.S. Cycle in Perspective

Negative Forces: Excessive Monetary Stimulus , Exchange Rate, Oil Prices and Household Financial Obligations



The U.S. Outlook – Graphic Portrayal

Blue Chip Financial Forecasts: Short-Term



Source: Blue Chip Financial Forecasts



The U.S. Outlook

Blue Chip Financial Forecasts: Long-Term Outlook

		-----Year-Over-Year, % Change-----					Five-Year Averages	
		<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2005-09</u>	<u>2010-14</u>
B. Real GDP	CONSENSUS	3.5	3.4	3.3	3.1	3.1	3.3	3.2
	Top 10 Average	3.9	3.8	3.8	3.8	3.8	3.8	3.6
	Bottom 10 Average	3.1	2.9	2.7	2.2	2.3	2.6	2.8
C. GDP Chained Price Index	CONSENSUS	2.2	2.3	2.3	2.2	2.2	2.3	2.2
	Top 10 Average	2.9	3.0	3.2	2.9	2.9	3.0	2.7
	Bottom 10 Average	1.8	1.9	1.9	1.8	1.8	1.8	1.8
D. Consumer Price Index	CONSENSUS	2.6	2.6	2.7	2.5	2.6	2.6	2.5
	Top 10 Average	3.2	3.2	3.5	3.2	3.3	3.2	3.1
	Bottom 10 Average	2.1	2.2	2.1	2.1	2.1	2.1	2.1

Source: *Blue Chip Financial Forecasts*, December 1, 2004

Baseline U.S. Outlook

Table 1

		2004				2005				2006				Year-over-Year Growth		
		I(A) 2004	II(A) 2004	III(A) 2004	IV(E) 2004	I(E) 2005	II(E) 2005	III(E) 2005	IV(E) 2005	I(E) 2006	II(E) 2006	III(E) 2006	IV(E) 2006	2004	2005	2006
1	Gross Domestic Product	11472.6	11657.5	11810.0	11953.9	12098.1	12252.5	12422.4	12581.3	12758.6	12928.2	13099.3	13272.9	6.5	5.2	5.5
2	Change*	5.5	5.4	5.4	5.0	4.9	5.2	5.7	5.2	5.8	5.4	5.4	5.4			
3	Gross Dom. Product ('96\$)	10697.5	10784.7	10889.7	10987.1	11092.2	11188.0	11289.8	11383.9	11491.2	11590.5	11683.9	11775.4	4.4	3.7	3.5
4	Change*	4.5	3.3	4.0	3.6	3.9	3.5	3.7	3.4	3.8	3.5	3.3	3.2			
5	Personal Consump. Exp. ('96\$)	7543.0	7572.4	7666.8	7735.2	7800.5	7863.0	7926.3	7984.0	8048.7	8111.4	8172.6	8233.4	3.7	3.5	3.1
6	Change*	4.1	1.6	5.1	3.6	3.4	3.2	3.3	2.9	3.3	3.2	3.1	3.0			
7	Equipment and Software ('96\$)	943.7	975.5	1015.0	1040.7	1064.5	1091.1	1118.3	1147.5	1176.9	1206.3	1233.9	1259.8	13.0	11.2	10.3
8	Change*	8.1	14.2	17.2	10.5	9.5	10.4	10.3	10.9	10.6	10.4	9.5	8.7			
9	Nonresid. Construction ('96\$)	237.7	241.7	241.5	242.7	242.9	242.9	242.9	242.7	242.7	242.9	243.0	242.9	1.5	0.8	0.0
10	Change*	-7.5	6.9	-0.3	2.0	0.3	0.1	0.0	-0.3	0.0	0.3	0.2	-0.1			
11	Resid. Construction ('96\$)	542.5	563.6	566.1	573.1	577.7	576.3	574.0	572.2	570.4	566.8	561.0	554.5	9.8	2.4	-2.1
12	Change*	5.0	16.5	1.8	5.0	3.2	-0.9	-1.6	-1.2	-1.2	-2.5	-4.0	-4.6			
13	Federal Defense ('96\$)	477.6	479.9	491.2	492.6	502.8	508.4	514.7	520.5	525.0	531.1	535.7	540.4	7.4	5.4	4.2
14	Change*	10.6	1.9	9.8	1.1	8.6	4.5	5.1	4.6	3.5	4.8	3.5	3.5			
15	Fed. Nondefense ('96\$)	235.4	237.9	234.7	235.9	237.1	238.4	238.7	240.1	241.2	242.4	243.4	244.6	-0.7	1.1	1.8
16	Change*	0.3	4.3	-5.3	2.1	2.0	2.2	0.4	2.3	1.9	2.0	1.7	2.1			
17	State + Local ('96\$)	1222.4	1228.3	1225.9	1229.8	1232.7	1238.0	1243.3	1249.1	1254.7	1260.5	1266.3	1272.1			
18	Change*	0.0	1.9	-0.8	1.3	0.9	1.7	1.7	1.9	1.8	1.9	1.8	1.9	0.6	1.2	1.8
19	Net Exports ('96\$)	-550.1	-580.3	-588.0	-594.3	-593.0	-594.4	-594.3	-596.3	-596.3	-596.8	-596.6	-596.4			
20	Chg. in Bus. Invent. ('96\$)	40.0	61.1	35.9	31.4	27.1	24.3	25.9	24.2	27.8	26.0	24.5	24.1			
21	Nonfarm Inventories	34.9	58.1	32.0	29.4	26.6	24.5	26.2	24.4	27.9	25.9	24.5	24.1			
22	Farm Inventories	5.1	3.0	3.9	2.1	0.4	-0.3	-0.3	-0.2	0.0	0.0	0.0	0.0			
23	GNP Deflator ('96=100) *	2.7	3.2	1.3	1.3	1.0	1.6	1.9	1.8	1.9	1.9	2.1	2.2	2.0	1.5	1.9
24	CPI (1982-84=100) *	3.6	4.7	1.9	2.3	1.9	2.3	2.7	2.5	2.5	2.6	2.9	2.9	2.6	2.4	2.6
25	PPI (1982=100) *	3.8	6.0	0.7	3.3	1.4	1.0	1.4	1.8	1.4	1.5	1.5	1.7	3.3	1.9	1.5

Cyclical Characteristics

Table 2

		2004				2005				2006				Year-over-Year Growth		
		I(A) 2004	II(A) 2004	III(A) 2004	IV(E) 2004	I(E) 2005	II(E) 2005	III(E) 2005	IV(E) 2005	I(E) 2006	II(E) 2006	III(E) 2006	IV(E) 2006	2004	2005	2006
1	Domestic Final Sales ('96\$)	11207.6	11303.9	11441.8	11549.9	11658.1	11758.2	11858.3	11956.0	12059.6	12161.4	12255.9	12347.7	4.1	3.5	3.3
2	Change	3.9	3.5	5.0	3.8	3.8	3.5	3.4	3.3	3.5	3.4	3.1	3.0			
3	Cyclical Domestic Demand ('96\$)	2799.4	2855.5	2940.8	2969.0	3002.2	3031.9	3064.0	3091.9	3127.8	3160.7	3189.3	3215.3	8.8	5.4	4.1
4	Change*	3.8	8.3	12.5	3.9	4.6	4.0	4.3	3.7	4.7	4.3	3.7	3.3			
5	Cyclical Consumer Demand ('96\$)	1075.5	1074.7	1118.2	1112.6	1117.2	1121.5	1128.9	1129.5	1137.8	1144.8	1151.3	1158.1	6.3	2.7	2.1
6	Change*	2.2	-0.3	17.2	-2.0	1.7	1.6	2.6	0.2	3.0	2.5	2.3	2.4			
7	Light Vehicles and Parts ('96\$)	456.7	449.6	478.7	467.8	466.3	465.2	470.3	466.2	471.2	475.3	478.9	481.7	2.5	0.8	2.1
8	Change*	-5.7	-6.1	28.5	-8.8	-1.3	-0.9	4.5	-3.4	4.4	3.5	3.1	2.4			
9	Other Durables ('96\$)	618.8	625.1	639.5	644.8	651.0	656.4	658.6	663.3	666.6	669.5	672.5	676.3	9.3	4.0	2.1
10	Change*	8.6	4.1	9.5	3.3	3.9	3.4	1.4	2.9	2.0	1.8	1.8	2.3			
11	Fixed Investment ('96\$)	1721.4	1778.3	1816.3	1856.5	1885.0	1910.4	1935.1	1962.4	1990.0	2015.9	2037.9	2057.2	10.2	7.3	5.3
12	Change*	7.2	7.2	7.3	9.1	6.3	5.5	5.3	5.7	5.7	5.3	4.4	3.8			
13	Resid. Construction ('96\$)	542.5	563.6	566.1	573.1	577.7	576.3	574.0	572.2	570.4	566.8	561.0	554.5	9.8	2.4	-2.1
14	Change*	5.0	16.5	1.8	5.0	3.2	-0.9	-1.6	-1.2	-1.2	-2.5	-4.0	-4.6			
15	Nonresid. Construction ('96\$)	237.7	241.7	241.5	242.7	242.9	242.9	242.9	242.7	242.7	242.9	243.0	242.9	1.5	0.8	0.0
16	Change*	-7.5	6.9	-0.3	2.0	0.3	0.1	0.0	-0.3	0.0	0.3	0.2	-0.1			
17	Equipment and Software ('96\$)	943.7	975.5	1015.0	1040.7	1064.5	1091.1	1118.3	1147.5	1176.9	1206.3	1233.9	1259.8	13.0	11.2	10.3
18	Change*	8.1	14.2	17.2	10.5	9.5	10.4	10.3	10.9	10.6	10.4	9.5	8.7			
19	Noncyclical Demand ('96\$)@	7898.1	7929.2	7948.9	8018.1	8090.0	8156.1	8225.8	8292.0	8363.4	8429.8	8494.6	8560.1	2.9	3.0	3.3
20	Change*	4.7	1.6	1.0	3.5	3.6	3.3	3.5	3.3	3.5	3.2	3.1	3.1			
21	Chg. in Business Inventories	40.0	61.1	35.9	31.4	27.1	24.3	25.9	24.2	27.8	26.0	24.5	24.1			
22	Gross Domestic Purchases ('96\$)&	11242.7	11360.8	11477.7	11581.4	11685.2	11782.4	11884.1	11980.2	12087.4	12187.3	12280.5	12371.8	4.8	3.7	3.4
23	Change*	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-5.8	3.1	3.1	3.1			
24	Net Exports ('96\$)	-550.1	-580.3	-588.0	-594.3	-593.0	-594.4	-594.3	-596.3	-596.3	-596.8	-596.6	-596.4			
25	GDP ('96\$)**	10697.5	10784.7	10889.7	10987.1	11092.2	11188.0	11289.8	11383.9	11491.2	11590.5	11683.9	11775.4	4.4	3.7	3.5
	Change*	4.5	3.3	4.0	3.6	3.9	3.5	3.7	3.4	3.8	3.5	3.3	3.2			

@ Noncyclical Demand = Consumer spending on nondurable goods and services and all forms of government spending (excluding CCC inventories)

& Gross Domestic Purchases = Domestic final demand plus changes in total inventories

* Quarter-to-quarter percent changes expressed at compound annual rates

A = Actual; E = Forecasts

Except for price indexes, all data in billions of dollars

Historical sources: BEA and BLS

December 6, 2004

Household Sector

Table 3

		2004				2005				2006				Year-over-Year Growth		
		I(A) 2004	II(A) 2004	III(A) 2004	IV(E) 2004	I(E) 2005	II(E) 2005	III(E) 2005	IV(E) 2005	I(E) 2006	II(E) 2006	III(E) 2006	IV(E) 2006	2004	2005	2006
1	Personal Income (\$ Bil.)	9445.0	9583.4	9654.8	9761.3	9855.0	9983.3	10094.7	10219.4	10339.5	10471.6	10595.6	10726.7	4.9	4.4	4.9
2	Change*	5.0	6.0	3.0	4.5	3.9	5.3	4.5	5.0	4.8	5.2	4.8	5.0			
3	Civilian Employment (Mil.)	138.4	138.8	139.6	140.0	140.5	140.9	141.3	141.7	142.1	142.5	142.9	143.2	1.1	1.3	1.1
4	Change*	0.1	1.2	2.4	1.2	1.3	1.2	1.2	1.1	1.2	1.1	1.0	1.0			
5	Unemployment Rate	5.6	5.6	5.4	5.3	5.3	5.2	5.2	5.1	5.1	5.0	5.0	5.0			
6	Personal Consump. Exp. ('96\$)	7543.0	7572.4	7666.8	7735.2	7800.5	7863.0	7926.3	7984.0	8048.7	8111.4	8172.6	8233.4	3.7	3.5	3.1
7	Change*	4.1	1.6	5.1	3.6	3.4	3.2	3.3	2.9	3.3	3.2	3.1	3.0			
8	Autos & Parts	1075.5	1074.7	1118.2	1112.6	1117.2	1121.5	1128.9	1129.5	1137.8	1144.8	1151.3	1158.1	2.5	0.8	2.1
9	Change*	2.2	-0.3	17.2	-2.0	1.7	1.6	2.6	0.2	3.0	2.5	2.3	2.4			
10	Other Durable Goods	456.7	449.6	478.7	467.8	466.3	465.2	470.3	466.2	471.2	475.3	478.9	481.7	9.3	4.0	2.1
11	Change*	-5.7	-6.1	28.5	-8.8	-1.3	-0.9	4.5	-3.4	4.4	3.5	3.1	2.4			
12	Nondurable Goods	618.8	625.1	639.5	644.8	651.0	656.4	658.6	663.3	666.6	669.5	672.5	676.3	4.4	3.7	3.3
13	Change*	8.6	4.1	9.5	3.3	3.9	3.4	1.4	2.9	2.0	1.8	1.8	2.3			
14	Services	2187.3	2188.0	2213.7	2234.9	2257.2	2277.5	2296.2	2315.9	2334.8	2353.3	2371.2	2388.8	2.8	3.3	3.3
15	Change*	6.7	0.1	4.8	3.9	4.0	3.7	3.3	3.5	3.3	3.2	3.1	3.0			
16	Lt. Vehicles	16.5	16.5	17.1	16.8	16.8	16.7	16.8	16.6	16.8	16.9	16.9	17.0	0.7	-0.1	1.0
17	Change*	-6.9	0.8	13.6	-5.6	-1.7	-1.6	3.1	-4.4	3.2	2.3	1.9	1.3			
18	New Auto Sales (Mil.)	7.4	7.5	7.3	7.5	8.5	8.5	8.6	8.5	8.5	8.6	8.6	8.7	-2.4	14.7	1.0
19	Change*	-4.2	1.4	-7.3	9.4	68.9	-1.6	3.1	-4.4	3.2	2.3	1.9	1.3			
20	New Light Truck Sales (Mil.)	7.3	7.3	7.3	9.3	8.2	8.2	8.2	8.1	8.2	8.3	8.3	8.3	5.7	4.8	1.0
21	Change*	-0.5	-0.4	-0.8	0.6	-0.4	0.2	0.0	-0.1	13.8	0.0	0.0	0.0			
22	Private Housing Starts (Mil.)	1.943	1.920	1.969	1.981	1.957	1.941	1.925	1.910	1.894	1.864	1.833	1.802	5.4	-1.0	-4.4
23	Change*	-16.8	-4.7	10.8	2.3	-4.8	-3.2	-3.1	-3.2	-3.2	-6.3	-6.4	-6.5			
24	Single-Family	1.570	1.596	1.634	1.645	1.625	1.613	1.600	1.588	1.575	1.550	1.525	1.500			
25	Multi-Family	0.373	0.323	0.335	0.336	0.332	0.328	0.325	0.322	0.319	0.314	0.308	0.302			
26	Existing Home Sales (Th.)	6203.3	6786.7	6676.7	6636.2	6566.6	6547.2	6528.0	6507.4	6791.3	6762.6	6734.4	6708.8	7.8	-0.6	3.2
27	Change*	0.0	0.0	0.0	-2.4	-4.1	-1.2	-1.2	-1.3	18.6	-1.7	-1.7	-1.5			

Corporate Sector

Table 4

		2004				2005				2006				Year-over-Year Growth		
		I(A) 2004	II(A) 2004	III(A) 2004	IV(E) 2004	I(E) 2005	II(E) 2005	III(E) 2005	IV(E) 2005	I(E) 2006	II(E) 2006	III(E) 2006	IV(E) 2006	2004	2005	2006
1	Fixed Business Invest.('96\$)	1173.0	1207.9	1245.3	1283.4	1307.3	1334.1	1361.2	1390.2	1419.5	1449.1	1476.9	1502.7	10.5	9.8	8.4
2	Change *	8.3	8.3	8.3	12.8	7.7	8.4	8.4	8.8	8.7	8.6	7.9	7.2			
3	Structures	237.7	241.7	241.5	242.7	242.9	242.9	242.9	242.7	242.7	242.9	243.0	242.9	1.5	0.8	0.0
4	Change *	-7.5	6.9	-0.3	2.0	0.3	0.1	0.0	-0.3	0.0	0.3	0.2	-0.1			
5	Producer Equip. & Software	943.7	975.5	1015.0	1040.7	1064.5	1091.1	1118.3	1147.5	1176.9	1206.3	1233.9	1259.8	13.0	11.2	10.3
6	Change *	8.1	14.2	17.2	10.5	9.5	10.4	10.3	10.9	10.6	10.4	9.5	8.7			
7	Chg. in Bus. Invent. ('96\$)	40.0	61.1	35.9	31.4	27.1	24.3	25.9	24.2	27.8	26.0	24.5	24.1			
8	Chg. In Nonfarm Inventories	34.9	58.1	32.0	29.4	26.6	24.5	26.2	24.4	27.9	25.9	24.5	24.1			
9	Corporate Profits (B.T.)	962.4	988.3	964.3	969.2	990.1	1013.1	1038.9	1068.4	1097.2	1122.3	1147.8	1174.1			
10	Corporate Profits (A.T.)	705.9	717.1	703.0	707.5	722.8	739.6	758.4	779.9	801.0	819.3	837.9	857.1	10.8	5.9	10.5
11	Change *	-4.4	6.5	-7.6	2.6	8.9	9.6	10.6	11.8	11.2	9.5	9.4	9.5			
12	Internal Funds (A.T.)	1059.6	1049.9	1071.8	1086.5	1109.6	1135.9	1164.5	1198.3	1229.7	1259.7	1289.8	1320.5	12.0	8.0	10.7
13	Change *	5.6	-3.6	8.6	5.6	8.8	9.8	10.5	12.1	10.9	10.1	9.9	9.8			
14	Dividends	403.4	413.2	424.0	433.5	441.6	448.9	456.2	463.5	471.0	478.6	486.2	493.9	5.9	8.1	6.6
15	Change*	7.3	10.1	10.9	9.3	7.6	6.8	6.7	6.5	6.7	6.6	6.5	6.4			
16	Output Per Hour*	4.0	2.7	2.4	2.7	2.9	2.6	2.8	2.5	2.9	2.6	2.5	2.5	3.9	2.7	2.7
17	Hourly Compensation*	4.2	4.2	4.2	3.6	3.4	3.4	4.0	3.8	4.2	3.9	3.9	4.0	4.0	3.6	3.9
18	Unit Labor Costs*	-1.0	1.4	1.7	0.9	0.5	0.9	1.2	1.2	1.3	1.3	1.4	1.5	0.1	1.0	1.3

International Sector

Table 5

		2004				2005				2006				Year-over-Year Growth		
		I(A) 2004	II(A) 2004	III(A) 2004	IV(E) 2004	I(E) 2005	II(E) 2005	III(E) 2005	IV(E) 2005	I(E) 2006	II(E) 2006	III(E) 2006	IV(E) 2006	2004	2005	2006
1	Net Exports ('96\$)	-550.1	-580.3	-588.0	-594.3	-593.0	-594.4	-594.3	-596.3	-596.3	-596.8	-596.6	-596.4			
2	Exports ('96\$)	1095.4	1114.8	1132.1	1154.0	1174.5	1197.8	1221.1	1245.5	1270.3	1295.7	1321.5	1347.9	8.9	7.6	8.2
3	Change*	7.3	7.3	6.4	8.0	7.3	8.2	8.0	8.3	8.2	8.2	8.2	8.2			
4	Imports ('96\$)	1645.5	1695.1	1720.1	1748.3	1767.5	1792.2	1815.4	1841.9	1866.6	1892.5	1918.0	1944.2	9.8	6.0	5.6
5	Change*	10.6	12.6	6.0	6.7	4.5	5.7	5.3	6.0	5.5	5.7	5.5	5.6			
6	Trade Weighted Index	85.3	88.0	86.5	82.3	80.6	80.7	81.0	81.6	82.1	82.7	83.1	83.9	-8.1	-5.3	2.4

Except where noted, all data in billions of dollars

Historical sources: BEA, BLS, and Federal Reserve

* Quarter-to-quarter percent changes expressed at compound annual rates

A = Actual; E = Forecasts

December 6, 2004

Outlook for Interest Rates

Market Based Forecasts: The Futures Market Over the Next Six Months

Futures market has seen persistent increase in the federal funds rate throughout the year

Expected increases in rates continue into 2005

Pattern of the rate increases gyrates as markets adjust to incoming data

- Employment gains for November were unexpectedly weak

As of close of business on 12/3/05, the federal funds futures contract puts the federal funds rate at around 2.75 percent by mid-2005

Prior to the employment announcement, expectations were for a federal funds rate of around 3% for the mid-2005



Source: Chicago Board of Options Trading
implied federal funds rate = 100 - contract price



Outlook for Interest Rates

Survey Results and the MTSU Outlook

Blue Chip Financial Forecast: 2005

- Short-term rates
 - Average forecasts puts the federal funds rate at 2.7% for the second quarter and 3.4% for the fourth quarter of 2005
- Long-term rates
 - Average forecasts puts the 10-year bonds at 4.8% in the second quarter and 5.1% in December 2005

Beyond 2005

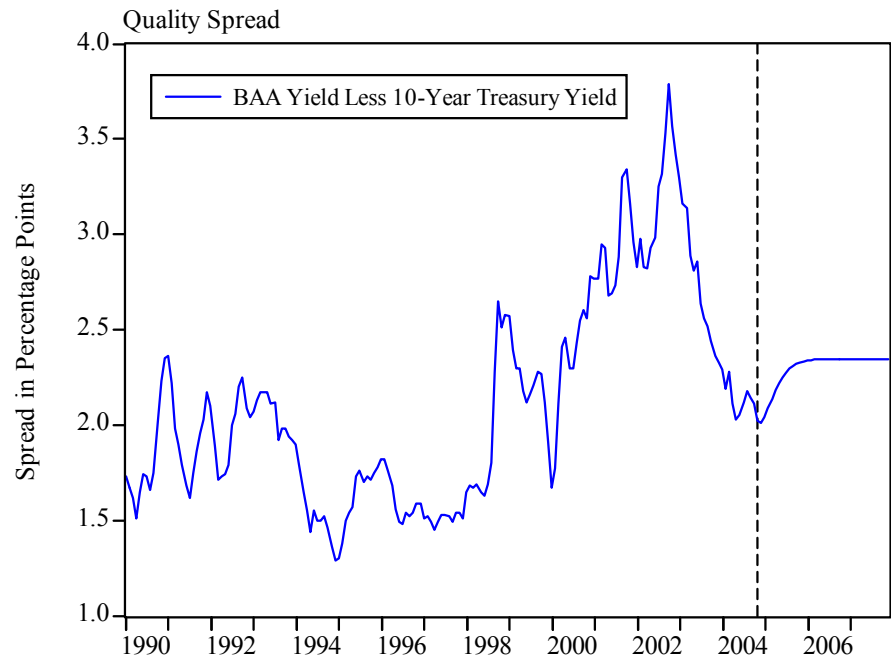
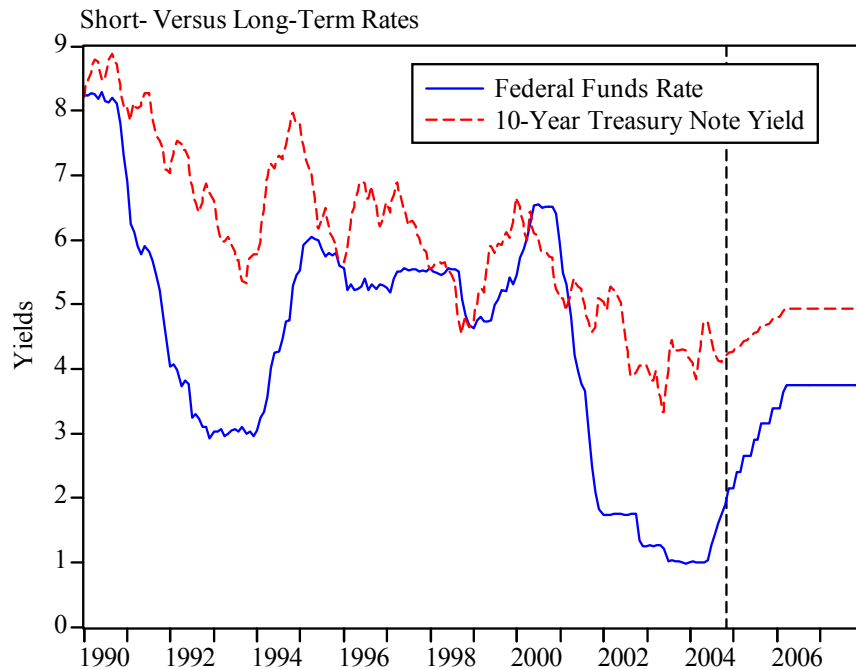
- Short-term rates
 - Federal funds rate is projected to average 4% in 2006 and rise to an average of close to 4.5 percent in 2007.
- Long-term rates
 - Yield on 10-year bond will average 5.5% in 2006 and continue to inch up, averaging 5.8% in 2008

Baseline MTSU forecast: 2005-2006

- Federal funds rate increases continue throughout 2005 and into early 2006
- Short-term rates will then remain stable through the remainder of the forecast horizon
- Speed of increase will balance strength of the expansion and inflation's potential against the need to drain liquidity injected during low-rate regime
- Continued removal of liquidity will keep long-term interest rates from rising dramatically during the forecast horizon
- Credit risk spreads have narrowed compared with early years of this decade
 - Bankruptcy risks have diminished
 - But, spreads are expected to rise from this level as the expansion ages
 - Spread is in line with the experience of the early 1990s and the late 1990s.

Interest Rate Outlook – Graphic Portrayal

MTSU Baseline Interest Rate Forecast



Money Market Interest Rates

Table 6

		2004				2005				2006				Annual Averages		
		I(A)	II(A)	III(A)	IV(E)	I(E)	II(E)	III(E)	IV(E)	I(E)	II(E)	III(E)	IV(E)	2004	2005	2006
		2004	2004	2004	2004	2005	2005	2005	2005	2006	2006	2006	2006			
1	Federal Funds	1.00	1.01	1.43	1.93	2.31	2.65	2.98	3.23	3.48	3.75	3.75	3.75	1.35	2.79	3.68
Commercial Paper																
2	1-Month	0.99	1.04	1.48	2.04	2.47	2.77	3.12	3.38	3.65	3.91	3.94	3.94	1.39	2.93	3.86
3	3-Month	1.01	1.09	1.54	2.10	2.54	2.87	3.20	3.47	3.73	4.01	4.02	4.03	1.43	3.02	3.95
4	6-Month	1.01	1.15	1.62	2.19	2.60	2.93	3.27	3.53	3.79	4.06	4.07	4.08	1.49	3.08	4.00
Finance Paper																
5	1-Month	1.01	1.06	1.50	2.05	2.46	2.75	3.10	3.35	3.62	3.88	3.90	3.90	1.41	2.92	3.82
6	3-Month	1.02	1.12	1.57	2.13	2.55	2.89	3.22	3.48	3.74	4.02	4.03	4.05	1.46	3.03	3.96
7	6-Month	1.03	1.20	1.66	2.21	2.60	2.93	3.27	3.52	3.77	4.04	4.05	4.05	1.52	3.08	3.98
Treasury Bills																
8	1-Month	0.93	1.10	1.51	2.07	2.43	2.75	3.07	3.32	3.56	3.82	3.82	3.81	1.40	2.89	3.75
9	3-Month	1.00	1.36	1.79	2.31	2.70	3.02	3.37	3.65	3.91	4.18	4.18	4.17	1.61	3.19	4.11
Negotiable CDs																
10	1-Month	1.03	1.10	1.55	2.11	2.54	2.84	3.20	3.46	3.74	3.99	4.01	4.01	1.45	3.01	3.94
11	3-Month	1.05	1.25	1.70	2.27	2.66	3.00	3.35	3.62	3.86	4.15	4.16	4.16	1.57	3.16	4.08
12	6-Month	1.11	1.48	1.93	2.44	2.85	3.19	3.55	3.83	4.11	4.38	4.38	4.39	1.74	3.36	4.32
Eurodollar Deposit																
13	1-Month	1.02	1.08	1.53	2.08	2.52	2.81	3.17	3.42	3.71	3.96	3.98	3.97	1.43	2.98	3.90
14	3-Month	1.04	1.23	1.68	2.25	2.64	2.99	3.34	3.60	3.85	4.14	4.15	4.15	1.55	3.14	4.07
15	6-Month	1.10	1.45	1.90	2.42	2.85	3.19	3.55	3.84	4.12	4.40	4.39	4.40	1.72	3.36	4.33

Capital Market Instruments

Table 7

		2004				2005				2006				Annual Averages		
		I(A)	II(A)	III(A)	IV(E)	I(E)	II(E)	III(E)	IV(E)	I(E)	II(E)	III(E)	IV(E)	2004	2005	2006
		2004	2004	2004	2004	2005	2005	2005	2005	2006	2006	2006	2006			
U.S. Treasury Notes and Bonds																
1	1-Yr Note	1.22	1.78	2.08	2.48	2.93	3.26	3.62	3.92	4.20	4.48	4.48	4.48	1.89	3.43	4.41
2	2-Yr Note	1.69	2.45	2.56	2.83	3.22	3.52	3.86	4.12	4.37	4.62	4.62	4.62	2.39	3.68	4.56
3	5-Yr Note	2.99	3.72	3.51	3.50	3.74	3.96	4.22	4.43	4.64	4.81	4.81	4.81	3.43	4.09	4.77
4	10-Yr Note	4.02	4.60	4.30	4.18	4.32	4.45	4.59	4.71	4.83	4.92	4.92	4.93	4.28	4.52	4.90
5	30-Yr Note	4.89	5.36	5.07	4.93	5.19	5.10	5.11	5.26	5.24	5.27	5.31	5.27	5.06	5.17	5.27
Other Bonds																
6	AAA Bonds	5.46	5.93	5.64	5.53	5.69	5.87	6.05	6.20	6.34	6.45	6.46	6.47	5.64	5.95	6.43
7	BAA Bonds	6.27	6.66	6.45	6.23	6.41	6.66	6.88	7.04	7.17	7.27	7.27	7.27	6.40	6.75	7.25
8	State and Local	4.52	4.98	4.71	4.53	4.49	4.49	4.55	4.62	4.70	4.77	4.77	4.77	4.69	4.53	4.75
Mortgage Rates - Primary Mkt																
9	30-Yr (FHLMC - PMMS)	5.36	5.93	5.60	5.08	5.71	5.92	6.05	6.22	6.38	6.50	6.53	6.55	5.49	5.98	6.49
10	15-Yr (FHLMC - PMMS)	4.55	5.23	4.92	4.48	5.13	5.40	5.54	5.77	6.02	6.19	6.18	6.18	4.79	5.46	6.14
11	ARM (FHLMC - PMMS)	3.53	3.88	4.05	4.14	4.49	4.87	5.30	5.67	6.01	6.34	6.37	6.40	3.90	5.08	6.28
Mortgage Rates - Secondary Mkt																
12	30-Yr (FLHMC Req Net Yield)	5.61	6.13	5.90	5.76	5.93	6.10	6.28	6.43	6.57	6.68	6.69	6.70	5.85	6.18	6.66
13	15-Yr (FHLMC Req Net Yield)	4.90	5.49	5.29	5.16	5.31	5.50	5.73	5.91	6.10	6.24	6.22	6.20	5.21	5.61	6.19
Cost of Funds Index																
14	US Average	2.17	2.10	2.12	2.26	2.46	2.67	2.85	3.04	3.21	3.36	3.49	3.57	2.16	2.75	3.41
15	11th FHLB District	1.82	1.76	1.87	2.08	2.36	2.64	2.89	3.13	3.35	3.57	3.71	3.80	1.89	2.76	3.61

Sources: Federal Reserve, Federal Home Loan Bank, Federal Home Loan Mortgage Corp.
A = Actual; E = Forecasts

December 1, 2004

The Tennessee Cycle in Perspective

Personal Income – Tennessee versus U.S.

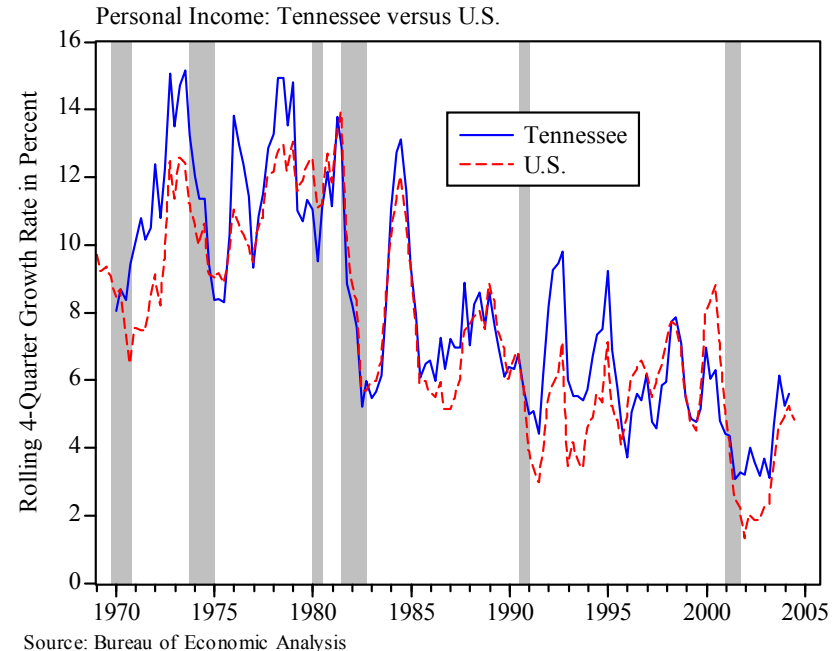
So far in this expansion, the rolling four-quarter growth of personal income for Tennessee is tracking the U.S. pattern

Quarterly growth in state and nation follows roughly the same cyclical pattern

- Historically, each 1% growth in the U.S. is met with 1% growth in Tennessee with a lapse of about 8 quarters
- Admittedly, there are sizeable short-run deviations between the two

Deceleration in income growth in U.S. was greater than Tennessee's experience in the last recession

Upswing in U.S. income growth has about matched Tennessee growth



The Tennessee Cycle in Perspective

Labor Markets – Tennessee versus U.S.

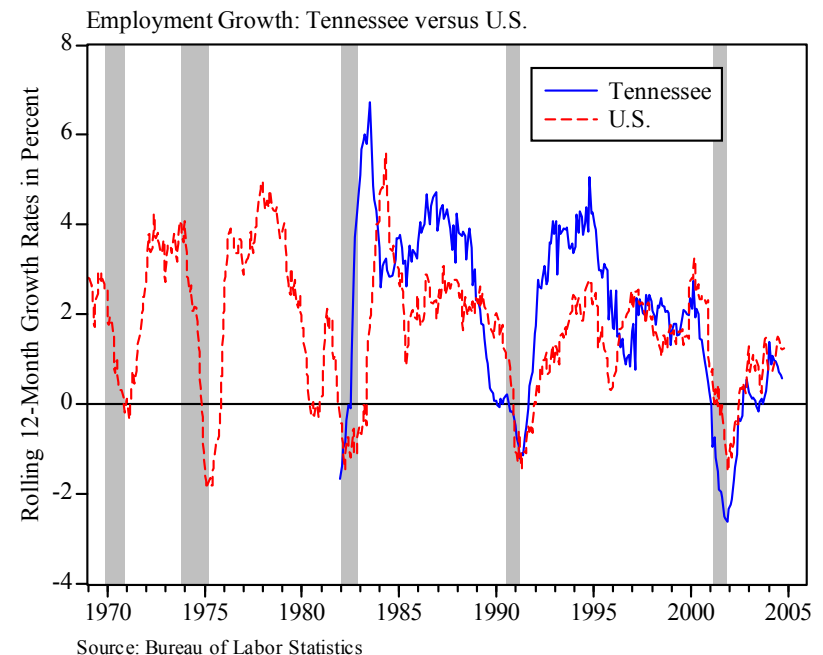
Tennessee's growth pattern moves roughly in tandem with U.S. over time but differences are evident

Pattern has tighter co-movement as decline gathers momentum

Historically, Tennessee typically had a stronger employment growth than the country as a whole in the upswing

Tennessee and U.S. are moving in closer tandem in this expansion

In this expansion, employment growth for Tennessee is in line with, not faster than, U.S. employment growth



The Tennessee Cycle in Perspective

Housing Activity – Tennessee versus U.S.

Housing in Tennessee generally moves with the U.S. housing cycle but with higher volatility

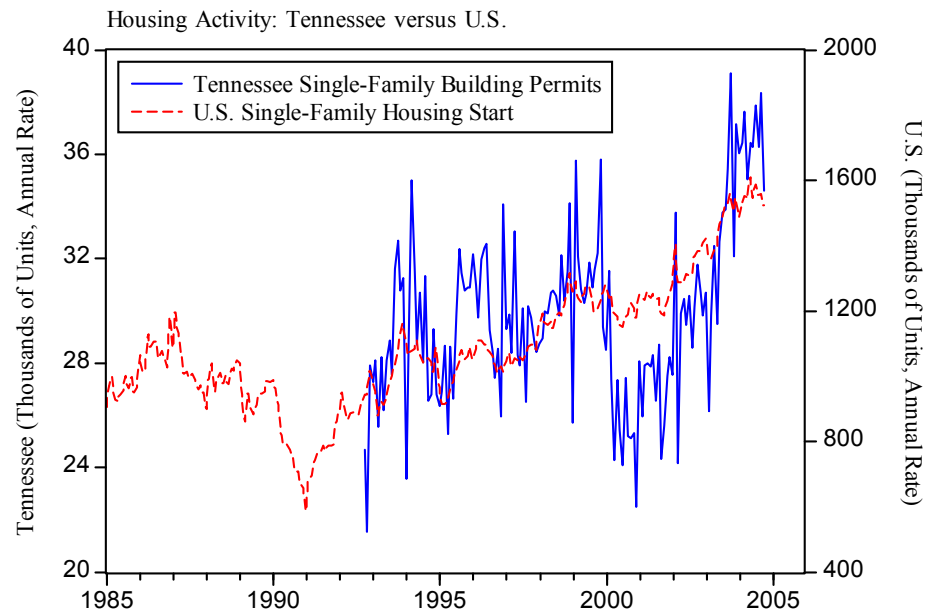
For 2002, 2003, and so far in 2004, housing in Tennessee seems to be in line with the historic experience

Rebound in late 2003 and 2004 is attributable to lower mortgage rates for both Tennessee and U.S.

Because of this, many see the housing boom as

- Largely the product of low interest rates and
- Too strong given the pace of job growth

Implications: Housing sector is vulnerable to a sharp slowdown in new permits



Source: Bureau of the Census

The Tennessee Cycle in Perspective

Consumer Spending

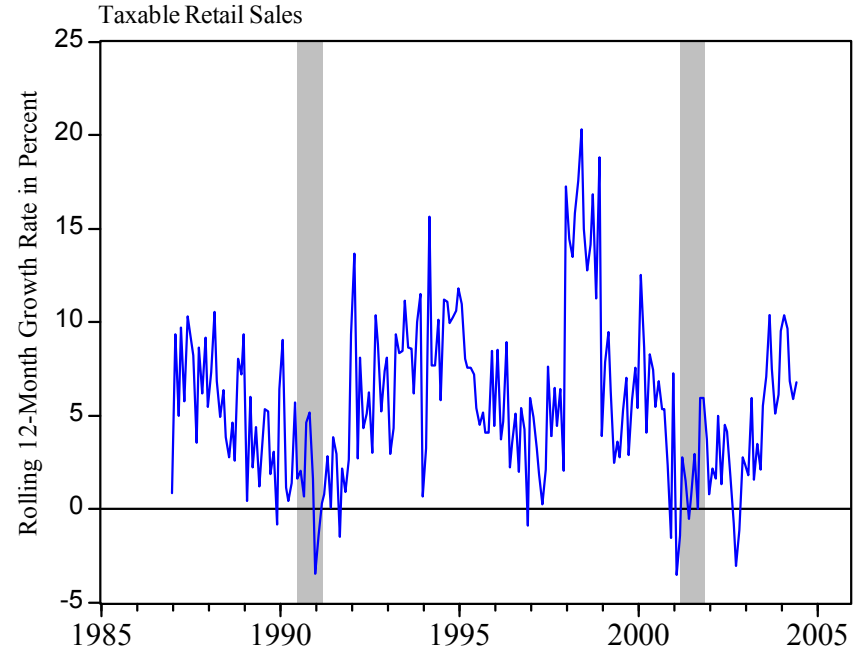
Current recovery: growth in taxable sales was slow longer than in the aftermath of the 1990 recession

- This reflects the lower inflation rate now compared with the aftermath of the 1990 recession

Now that expansion is established, growth is about in line with that experienced in the last recession

Since inflation is lower, this represents stronger growth in real terms compared with the last expansion

Problem: strength of retail spending may be stronger than supportable by employment



Baseline Tennessee Outlook

Table 8

	2004				2005				2006				Year-over-Year Growth		
	I(A) 2004	II(A) 2004	III(A) 2004	IV(E) 2004	I(E) 2005	II(E) 2005	III(E) 2005	IV(E) 2005	I(E) 2006	II(E) 2006	III(E) 2006	IV(E) 2006	2004	2005	2006
National Trends															
1 Civilian Employment (Mil.)	138.4	138.8	139.6	140.0	140.5	140.9	141.3	141.7	142.1	142.5	142.9	143.2	1.1	1.3	1.1
2 Change*	0.1	1.2	2.4	1.2	1.3	1.2	1.2	1.1	1.2	1.1	1.0	1.0			
3 Personal Income	9445.0	9583.4	9654.8	9761.3	9855.0	9983.3	10094.7	10219.4	10339.5	10471.6	10595.6	10726.7	4.9	4.4	4.9
4 Change*	5.0	6.0	3.0	4.5	3.9	5.3	4.5	5.0	4.8	5.2	4.8	5.0			
5 Income Per Employee (T)	68.250	69.048	69.157	69.712	70.159	70.866	71.446	72.133	72.765	73.485	74.161	74.900	3.8	3.1	3.8
6 Change*	5.0	4.8	0.6	3.2	2.6	4.1	3.3	3.9	3.6	4.0	3.7	4.0			
7 Housing Start (Mil. of Units)	1.943	1.920	1.969	1.981	1.957	1.941	1.925	1.910	1.894	1.864	1.833	1.802	5.4	-1.0	-4.4
8 Change*	-16.8	-4.7	10.8	2.3	-4.8	-3.2	-3.1	-3.2	-3.2	-6.3	-6.4	-6.5			
Tennessee															
9 Nonagricultural Employment (T)	2686.7	2687.9	2688.6	2690.1	2692.6	2696.2	2700.8	2706.3	2712.5	2719.1	2725.9	2733.2	0.8	0.4	0.9
10 Change*	1.4	0.2	0.1	0.2	0.4	0.5	0.7	0.8	0.9	1.0	1.0	1.1			
11 Personal Income	172.5	174.8	175.9	177.6	179.3	181.4	183.4	185.6	187.8	190.1	192.3	194.8	5.0	4.1	4.8
12 Change*	4.8	5.4	2.6	4.1	3.8	4.8	4.4	4.9	4.7	5.0	4.9	5.1			
13 Dividends & Interest	21.9	22.0	22.3	22.5	22.8	23.1	23.4	23.7	24.0	24.3	24.6	24.9	4.2	4.8	5.2
14 Change*	4.7	2.8	4.4	5.3	4.7	5.2	4.9	5.2	5.2	5.4	5.2	5.4			
15 Income Per Employee (T)	64.195	65.014	65.408	66.034	66.597	67.292	67.911	68.581	69.218	69.902	70.563	71.256	4.2	3.7	3.9
16 Change*	3.4	5.2	2.4	3.9	3.5	4.2	3.7	4.0	3.8	4.0	3.8	4.0			
17 Rerail Sales	74.0	72.7	74.3	75.2	76.4	77.6	78.8	80.1	81.4	82.6	83.6	84.8	6.9	5.7	6.2
18 Change*	20.7	-6.8	8.6	5.3	6.4	6.7	6.4	6.7	6.4	5.9	5.3	5.7			
19 Building Permits (T)	36.697	35.911	37.502	34.831	33.288	34.248	34.144	33.923	33.660	32.500	31.991	31.548	10.7	-6.4	-4.4
20 Change*	6.5	-8.3	18.9	-25.6	-16.6	12.1	-1.2	-2.6	-3.1	-13.1	-6.1	-5.4			

Note: Except where noted, all data in billions of dollars. Historic sources: BEA, BLS, State of Tennessee

T=Thousands of units, persons, or dollars

* Quarter-to-quarter percent changes expressed at compound annual rates.

December 7, 2004

Prospects for Tax Revenue: Funding Board Estimates -- May 2004

Table 9

	FY93-94	FY94-95	FY95-96	FY96-97	FY97-98	FY98-99	FY99-00	FY00-01	FY01-02	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07	FY07-08
1 Total Tax Revenue*	5505.5	5767.1	6071.7	6415.1	6791.0	7030.3	7558.5	7636.3	7508.6	8505.3	9121.0	9404.8			
2 Chg@	1.2	4.8	5.3	5.7	5.9	3.5	7.5	1.0	-1.7	13.3	7.2	3.1			
3 Sales and Use Tax*	3370.2	3477.0	3673.8	3906.7	4102.7	4337.3	4608.3	4642.7	4654.7	5455.2	5806.5	6096.6			
4 Chg@	-2.1	3.2	5.7	6.3	5.0	5.7	6.2	0.7	0.3	17.2	6.4	5.0			
5 Income Tax*	100.3	101.3	114.5	128.9	160.4	160.6	180.2	198.6	144.5	116.8	139.8	141.8			
6 Chg@	5.6	1.0	13.0	12.6	24.5	0.1	12.2	10.2	-27.2	-19.2	19.7	1.4			
7 Gross Receipts Tax*	165.6	180.6	175.9	189.0	188.4	199.3	213.5	216.8	223.9	216.3	218.6	227.4			
8 Chg@	-0.7	9.0	-2.6	7.4	-0.3	5.8	7.1	1.5	3.3	-3.4	1.1	4.0			
9 Excise plus Franchise Taxes*	677.9	777.0	816.1	888.5	913.8	893.4	1074.3	1112.1	968.4	1085.0	1181.9	1146.1			
10 Chg@	12.0	14.6	5.0	8.9	2.8	-2.2	20.3	3.5	-12.9	12.0	8.9	-3.0			
11 Gasoline Tax*	552.6	528.3	535.9	543.3	563.2	567.9	576.6	569.4	576.9	600.9	600.9	617.6			
12 Chg@	12.6	-4.4	1.4	1.4	3.7	0.8	1.5	-1.3	1.3	4.2	0.0	2.8			
13 Vehicle Registration*	165.6	179.5	185.2	184.2	196.5	201.5	219.3	212.1	221.2	226.8	240.5	244.1			
14 Chg@	6.3	8.4	3.1	-0.5	6.6	2.6	8.8	-3.3	4.3	2.5	6.0	1.5			
15 Fuel Tax*	111.2	122.2	126.7	126.8	133.2	142.5	152.8	146.8	151.2	154.8	168.8	171.6			
16 Chg@	5.9	9.9	3.7	0.1	5.0	7.0	7.2	-3.9	3.0	2.4	9.0	1.7			
17 Privilege Tax*	125.6	123.8	139.9	150.7	171.0	191.9	186.6	190.1	207.9	248.6	276.9	287.0			
18 Chg@	15.3	-1.4	12.9	7.8	13.4	12.2	-2.8	1.9	9.4	19.6	11.4	3.7			
19 All Other Taxes*	236.4	277.3	303.7	296.8	361.8	335.9	346.9	347.7	359.9	401.0	487.2	472.6			
20 Chg@	-12.3	17.3	9.5	-2.3	21.9	-7.2	3.3	0.2	3.5	11.4	21.5	-3.0			

Prospects for Tax Revenue: MTSU Forecast -- December 2005

Table 10

Tennessee Economic Assumptions (Fiscal-Year Basis)

	FY93-94	FY94-95	FY95-96	FY96-97	FY97-98	FY98-99	FY99-00	FY00-01	FY01-02	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07	FY07-08
1 Personal Income (Bil \$)	102.1	110.0	115.2	121.6	128.9	137.0	144.9	152.1	157.2	162.5	171.3	178.6	186.7	196.0	205.5
2 Chg@	5.9	7.7	4.8	5.5	6.0	6.3	5.7	5.0	3.4	3.4	5.4	4.2	4.6	5.0	4.9
3 Nonagricultural Employments (Mil)	2.4	2.5	2.5	2.6	2.6	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.8
4 Chg@	3.8	3.9	2.2	1.4	2.1	1.9	2.1	0.2	-2.0	0.1	0.5	0.4	0.7	1.0	1.0
5 Income Per Employee (Th \$)	43.0	44.6	45.7	47.6	49.4	51.5	53.4	55.9	59.0	61.0	63.9	66.3	68.9	71.6	74.4
6 Chg@	2.0	3.7	2.5	4.0	3.8	4.4	3.6	4.8	5.5	3.3	4.8	3.8	3.9	3.9	3.9
7 Retail Sales (Bil \$)	40.7	44.5	46.8	48.3	53.5	58.8	62.6	64.1	65.9	67.0	72.1	75.9	80.7	85.5	90.1
8 Chg@	8.3	9.3	5.3	3.1	10.8	9.9	6.5	2.4	2.9	1.7	7.5	5.3	6.4	5.8	5.5
9 Building Permits (Th of Units)	30.1	27.6	31.3	29.2	29.4	31.2	29.7	26.3	28.0	30.2	35.8	35.0	33.6	31.7	30.2
10 Chg@	13.9	-8.2	13.5	-6.8	0.7	6.0	-4.7	-11.3	6.4	8.0	18.3	-2.3	-4.0	-5.6	-4.6

Revenue Forecasts

11 Total Tax Revenue*	5505.5	5767.1	6071.7	6415.1	6791.0	7030.3	7558.5	7636.3	7508.6	8505.3	9121.0	9408.2	9731.1	10117.2	10505.3
12 Chg@	1.2	4.8	5.3	5.7	5.9	3.5	7.5	1.0	-1.7	13.3	7.2	3.1	3.4	4.0	3.8
13 Sales and Use Tax*	3370.2	3477.0	3673.8	3906.7	4102.7	4337.3	4608.3	4642.7	4654.7	5455.2	5806.5	6011.9	6241.7	6501.0	6766.8
14 Chg@	-2.1	3.2	5.7	6.3	5.0	5.7	6.2	0.7	0.3	17.2	6.4	3.5	3.8	4.2	4.1
15 Income Tax*	100.3	101.3	114.5	128.9	160.4	160.6	180.2	198.6	144.5	116.8	139.8	147.1	155.3	164.3	173.4
16 Chg@	5.6	1.0	13.0	12.6	24.5	0.1	12.2	10.2	-27.2	-19.2	19.7	5.2	5.6	5.8	5.6
17 Gross Receipts Tax*	165.6	180.6	175.9	189.0	188.4	199.3	213.5	216.8	223.9	216.3	218.6	228.0	238.9	247.8	255.5
18 Chg@	-0.7	9.0	-2.6	7.4	-0.3	5.8	7.1	1.5	3.3	-3.4	1.1	4.3	4.8	3.7	3.1
19 Excise plus Franchise Taxes*	677.9	777.0	816.1	888.5	913.8	893.4	1074.3	1112.1	968.4	1085.0	1181.9	1205.7	1242.6	1292.0	1339.3
20 Chg@	12.0	14.6	5.0	8.9	2.8	-2.2	20.3	3.5	-12.9	12.0	8.9	2.0	3.1	4.0	3.7
21 Gasoline Tax*	552.6	528.3	535.9	543.3	563.2	567.9	576.6	569.4	576.9	600.9	600.9	615.2	618.0	623.0	628.0
22 Chg@	12.6	-4.4	1.4	1.4	3.7	0.8	1.5	-1.3	1.3	4.2	0.0	2.4	0.5	0.8	0.8
23 Vehicle Registration*	165.6	179.5	185.2	184.2	196.5	201.5	219.3	212.1	221.2	226.8	240.5	248.0	259.0	263.3	269.6
24 Chg@	6.3	8.4	3.1	-0.5	6.6	2.6	8.8	-3.3	4.3	2.5	6.0	3.1	4.4	1.6	2.4
25 Fuel Tax*	111.2	122.2	126.7	126.8	133.2	142.5	152.8	146.8	151.2	154.8	168.8	173.5	180.0	185.9	192.1
26 Chg@	5.9	9.9	3.7	0.1	5.0	7.0	7.2	-3.9	3.0	2.4	9.0	2.8	3.7	3.3	3.3
27 Privilege Tax*	125.6	123.8	139.9	150.7	171.0	191.9	186.6	190.1	207.9	248.6	276.9	289.9	294.4	325.1	351.9
28 Chg@	15.3	-1.4	12.9	7.8	13.4	12.2	-2.8	1.9	9.4	19.6	11.4	4.7	1.6	10.4	8.3
29 All Other Taxes*	236.4	277.3	303.7	296.8	361.8	335.9	346.9	347.7	359.9	401.0	487.2	488.8	501.1	514.8	528.7
30 Chg@	-12.3	17.3	9.5	-2.3	21.9	-7.2	3.3	0.2	3.5	11.4	21.5	0.3	2.5	2.7	2.7

* Millions of dollars

@ Annual Percent Change

Annual economic data in lines 1, 3, 5, 7, and 9 are calculated in terms of fiscal years ending in IIQ of the calendar year of the noted fiscal year

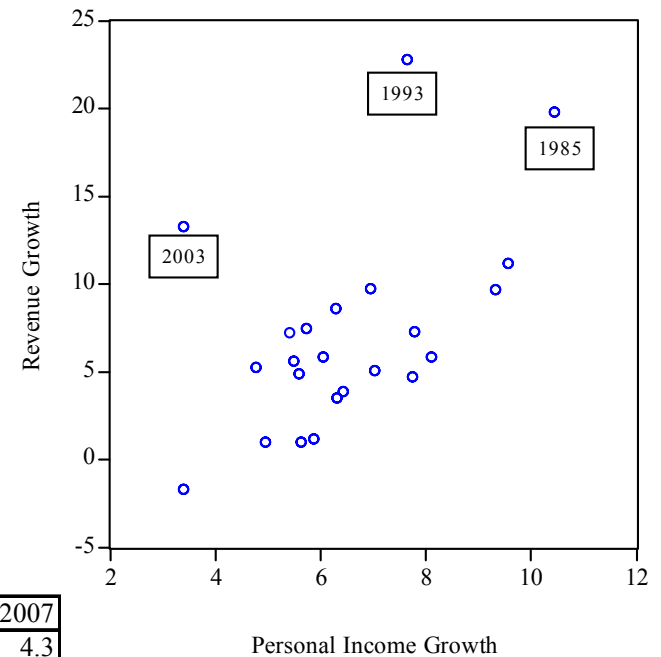
December 7, 2004

A Consistency Check

Top-down forecasting model projects growth in tax revenue based on personal income growth, controlling for tax rate changes in 1985, 1993, and 2003

Based on personal income projections, the consistency check is below

	FY2003	FY2004	FY2005	FY2006	FY2007
Revenue Growth	13.3	7.2	3.7	3.9	4.3
Revenue (millions of \$)	8505.3	9121.0	9454.0	9827.1	10248.5
Personal Income Growth	3.4	5.4	4.2	4.6	5.0





Contingency Views

Balancing the Risks

Probabilities

- Stronger growth 25%
- Baseline 50%
- Weaker growth 25%

Tilting the balance to weak-growth scenario:

Asymmetric cost of forecast errors

- Lower than projected tax revenue is a bigger problem for the state than higher than projected tax revenue
- *Risk scenario*
 - Faltering U.S. growth with spillover effects to Tennessee
 - Personal income growth in Tennessee is 2 percent less in 2005 and 2006

The risk outlook, based on the consistency model, is reported in the adjacent panel

Risk Scenario

	FY2005	FY2006
Revenue Growth	1.9	2.2
Revenue (millions of \$)	9296.2	9502.3
Personal Income Growth	2.2	2.4



The U.S. Outlook – Problem Areas

Monitoring the Likelihood of Weaker Than Projected Growth

Winning the peace

- Uncertainty over the situation in Iraq remains
- Effects of this uncertainty may fall more heavily on the dollar than directly on the U.S. economy

Pricing power

- Global capacity limits the ability of manufacturing to secure price increases, which affects ability to manage earnings
- Prices of goods less energy (CPI basis) advanced a scant 0.07% over the last 12 months.
- At least deflation in this sector has ended; over the prior 12 months, prices of goods less food and energy fell 2.5%

Sector problems

- Housing and vehicle sales supported by low interest rates
- Defined-benefit pensions remain underfunded but are attracting less political attention
- Healthcare costs are impacting earnings and are a hot political issue

The building dollar problem

- Dollar fall continues
 - Dollar currently \$1.34 per euro
 - It was \$0.88 per euro in early 2002
- Private foreign appetite for dollar instruments is weakening
- Most of the capital inflow is through official foreign institutions
- Russia indicates that it may increase reserve holdings of euros
- ECB may hold back on purchases of dollar
- U.S. officials seem okay with weaker dollar

Implications

- So far, lack of interest in dollar assets has not led to higher U.S. long-term rates
- But, there is a risk of a dollar rout
- If so, it is unlikely that currency support by central banks could hold back the effects
- Effects would be felt on dollar assets as foreigners repatriate funds
- Low probability on dollar rout, but probability is greater than zero